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# A Snapshot of Asset Allocators' Views

We spent several days in late January with a group of Chief Investment Officers and senior asset allocators. This was useful both as a way to hear the key concerns for a significant group of investors and as an opportunity to think about what one might do in response. The focus of the discussions was very much strategic, so (thankfully) the path of central-bank interest rates and soft versus hard economic landing were not among the topics. Instead, the debate was on structural macro forces, the long-term outlook for returns, how various parts of the investment industry might fare, and what all this means for the broader economy. In this short note, we will summarize a few of the key topics that we think are of general interest.

In terms of practical implications for portfolios, our conclusion is that a majority of institutional investors plan to increase further their allocation to private assets, but that there is much disagreement about what level of returns to expect (especially for private equity). There is also a range of views about the appropriate lens from which to view the risk of such assets, and a lot of discussion about the design of pension portfolios and what level of returns are required.

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## Inflation and a New Paradigm

There was general agreement that the strategic outlook for inflation is higher and a majority view held that real growth will be lower. Abstracting beyond the cyclical outlook, the idea that the inflation rate 10 years forward will be higher than that seen over the pre-COVID decade did not seem at all controversial, to the point that there was no argument on this point. This is striking, as (1) this is not the message from 10-year breakeven rates, which imply inflation in the low two-percent range, and (2) despite people apparently signing on to a higher-inflation future, we would argue that this does not seem to be reflected in a commensurate change in portfolio allocations.

There were questions asked about the level of inflation versus its direction. It may be easy to articulate a narrative of why equilibrium inflation is headed upward, but how much confidence can one have in the magnitude of the move, especially in the context of disinflationary forces (lower growth and automation)? In our view, US inflation 10 years forward will be closer to 3% than 2%, but we agree that it would be a brave economist who assigned coefficients to the forces that seem most relevant to inflation in the future, because we haven't seen this set of economic circumstances before.

A view was also expressed that perhaps some of the apparent inflationary impetus is really just a one-off step change in prices (for example, the energy transition) rather than inflation per se. We push back on this argument: We think there is a case for why wages should be higher in a sticky way. However, if that is the view, the volatility of inflation rather than the level might be the real change. We would agree that there are good reasons to expect higher inflation volatility, including deglobalization, higher public debt, and a greater role for fiscal versus monetary policy.

The bottom line: expecting inflation to be higher over the next decade appears, from our conversations at least, to be boringly consensus, but the view on what to do about it varies.

A clear majority of allocators we spoke to seemed to agree that we are indeed in a new regime. Some went further by implying that the description of a new regime did not fully capture the magnitude of the shift we are seeing, with climate change, demographics, deglobalization and AI representing nothing short of a paradigm change.

We like the paradigm-change description. After all, Kuhn first outlined this concept for when a break of sufficient magnitude changes the rules, with the old rules (or rules of thumb when it comes to investing) needing to be rejected. But more than that, a paradigm change in the Kuhnian sense often entails a metaphysical shift, too. Investing never gets to dabble in metaphysics (with good reason), but we would suggest that the equivalent in finance is a change in a notion of benchmarks as well as the required target and framework for investing.

## Private Assets and Active Management

If we were to take away just one asset-allocation conclusion from these meetings, it would be that the weight on private assets is rising. This move is in part a reflection of the need for a certain level of return; it also reflects a view of where available returns might come from. The agreement among guests, however, stops there. There was an animated discussion on the expected returns from private assets, in particular how much of the private equity return is "beta" versus "alpha" and how much is repeatable.

In our own work, we have published an expected net-of-fee return from the average private equity investment that is in line with that which we expect in public equities. But we would agree that return dispersion is a key differentiating feature of the asset class. This notion cuts both ways, of course, but it can be used as an argument for the ability to extract alpha.

The disagreement over expected returns from private assets is hardly surprising, given both the relatively short historical window available from which to collect data on the efficacy of this kind of investing and the distinction between how much of the experience so far has stemmed from a special set of macro conditions versus actual skill in selecting and managing assets.

There was more agreement on the idea that not all "illiquid" assets are created equally when it comes to liquidity. The time required to see a return on investment, the overall horizon of committed capital and the mechanism that could cause returns to fall short of expectations are very different between private equity and private debt. Given an outlook that implies greater liquidity needs rather than less, we believe this implies the marginal flow from this point is headed into private debt, not equity. Finding agreement on the expected-return axis of a return/risk chart is hard enough when it comes to alternative assets; finding

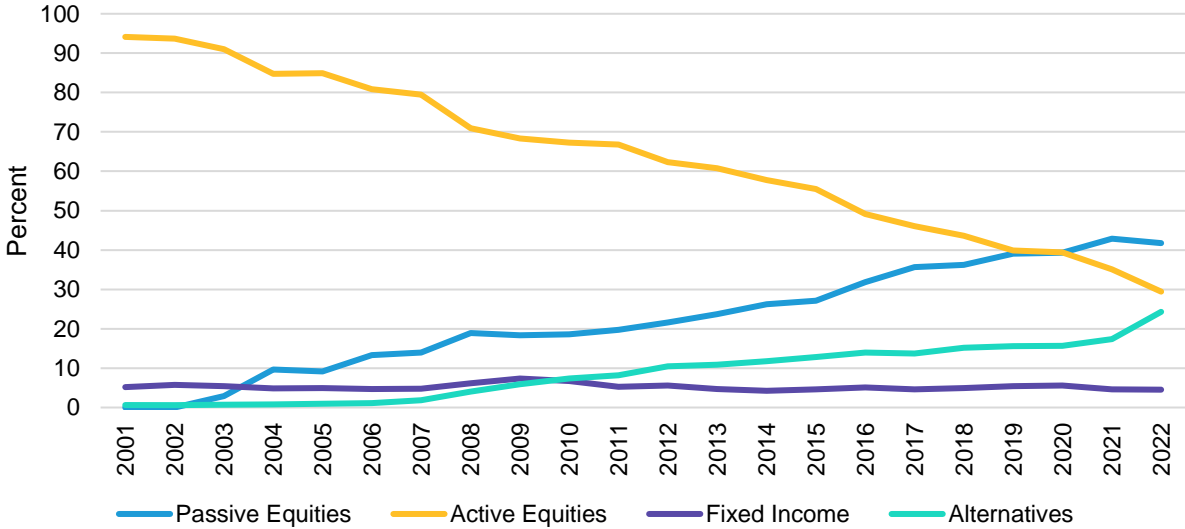
agreement on the risk axis is even harder! We think that, if anything, the combination of tail risk, volatility, liquidity and protection of purchasing power is even more critical for determining the appropriate allocation to these assets.

The pushback on this view is either 1) the view that any less-liquid allocation should perhaps be saved for the highest possible returning assets or 2) possible concern about the relative youth of the private debt industry, at least in its expanded form. Is there enough experience of default cycles and what would happen should a sharp slowdown arrive?

Hand in hand with the open door to higher allocations to private assets was a discussion of the role of active returns more generally. We found some agreement on the notion that, in a world where the expected return from asset-class betas falls, there is a potentially larger role for active. Or, to put it another way, the ability to buy into “alpha” would be particularly useful in a period of low returns. We also found agreement with our contention that idiosyncratic alpha (i.e., alpha stripped of simple factor betas) is a more appropriate goal than simple alpha measured as excess return.

However, all the evidence points to a continuing monotonic barbell of exposures. Risk budgets and capital allocations associated with active public market investing continue to fall in a straight line while capital and risk is instead allocated to alternatives and passive liquid market exposures (*Display 1*).

**DISPLAY 1: RISK CONTRIBUTION FROM US PENSION FUNDS BY ASSET CLASS**



**Historical analysis and does not guarantee future results.**

We use the capital allocation of US pension plans as the base, and assume that “alternatives” is a 50:50 combination of private equity and hedge funds. For private equity, we have used a public-market-equivalent time series (essentially a smaller-cap, value-tilted index with leverage). For hedge funds, we have used the HFRX Aggregate Index. Given constraints on data availability for alternatives, we use a constant variance/covariance matrix over the full time period, rather than a rolling one. For fixed income, we use the Bloomberg Global Aggregate Total Return Index.

As of December 31, 2022

Source: Public Pension Plan Database, Thomson Reuters Datastream and AB

**Strategic Asset Allocation... and Governance**

The discussion of regimes and expected returns from private assets leads, with a certain inevitability, to the question of strategic asset allocation.

There was a debate about how to protect portfolios from a loss of purchasing power. One view expressed was that the resource transition gives a potential route to returns that can offer some inflation protection over long horizons. This can include exposure to critical materials, farmland and forestry.

It can be hard to make generalized normative statements about what strategic asset allocation is right, given differences in benchmarks, time horizons and liquidity needs. It is clear that heuristics have traditionally played a huge role in determining these allocations; we would argue this is partly because there is no natural cross-asset benchmark (the topic of a forthcoming note). The 60:40 portfolio is the most famous such structure, but this issue exists even in the way silos are set (e.g., in any division between liquid and illiquid assets).

We suggest that asset-class betas, factors and alpha (in both alternatives and traditional asset management) are all important, so we presented a systematic technique for appropriately allocating risk across these categories. This approach still requires investors to articulate how they want to frame the tradeoffs they face. For example, do they wish to trade off return against risk measured as volatility (i.e., a max-Sharpe-ratio approach), or are there other criteria in terms of liquidity and purchasing-power protection that are more important? Does the investor care about adhering closely to what other investors do (be that a 60:40 or some version augmented with a significant exposure to real estate and private equity)?

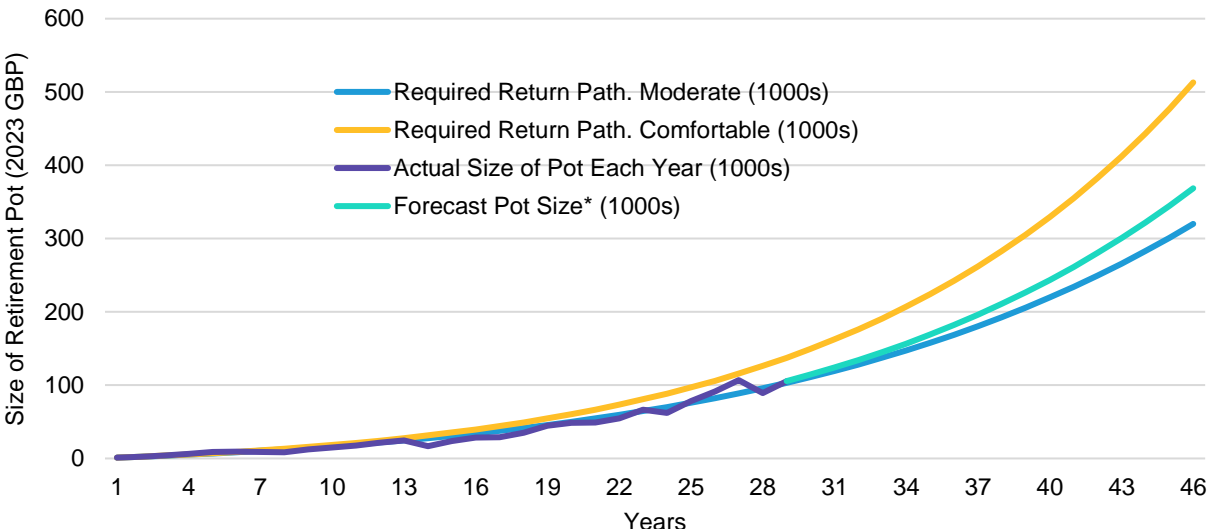
This issue is the reason why we found many of the strategic asset allocation discussions ending up as conversations about governance and agency considerations. This course is especially true if the contention is that the paradigm has changed. However, guidelines on governance, target returns and risk are—rightly—made only very slowly and humbly, so this change may still be in the offing.

**What Returns are Actually Needed, Anyway?**

The discussions with allocators touched on questions related to the design of pension systems and what return is needed. Our own research implies that, while target-date funds have broadly done a good job, even the past decade of strong financial market returns has not resulted in an extra cushion being built up to guard against a future of lower returns and higher inflation.

For example, the cohort of 2040 target-date funds have delivered a 4.25% annualized real return since 1995. If we use the UK as an example, the Pension and Lifetime Savings Association suggests that the minimum annual income required to retire is one-third of the median national salary. For a “moderate” retirement, that amount rises to two-thirds of the median salary, and for a “comfortable” retirement it is slightly over the national median salary. Our model suggests that from the current level, 2040 target-date funds would have to return 4% per annum in real terms from now to maturity in order to meet the “moderate” level; a real return as high as 7.5% would be needed to meet the “comfortable” level (*Display 2*).

**DISPLAY 2: 2040 TARGET DATE REQUIRED AND ACTUAL RETURN**



**Historical analysis and does not guarantee future results.**

\* Assuming 5% Real Return  
 As of January 18, 2024  
 Source: eVestment, Thomason Reuters Datastream and AB

The prospect of both lower real returns and higher inflation makes these targets harder to achieve, leading to a series of choices about working longer, saving more, requiring more of a social safety net (i.e., shifting the risk to the government), or taking greater risk. There has already been a shift to later retirement ages in recent years. However, for portfolio design, this entails an active debate about how to move from simply having the largest savings pot to ensuring the best income during retirement. We heard an active debate about the role of annuities and insurance products in strategic asset allocation as a result.

The other part of the debate about pension design and required returns revolved around achieving goals via pension savings that are not directly financial, such as enabling the energy transition, sustainability and social fairness. The squeeze on real incomes has already made the energy transition a point of political debate—an analogous debate is taking place around the structure of pension assets, especially at the lower end of the wage level, which leaves no room for error in terms of retirement outcomes.

## Conclusion

Overall, our take on the time we spent with allocators and investors suggests that the direction of equilibrium inflation is not really a topic of disagreement. Exactly how high inflation will be in the long term, and what to do about it in portfolios, prompted a broader dispersion of views.

The rotation from public to private markets has been under way for over a decade and looks set to continue, albeit for somewhat different reasons. In the past, the animus was a hunt for yield; now, the rotation is driven more by the need for real returns, diversification and a view on where active returns are available. This evolution also reflects a change in how capital is raised. There is disagreement among investors about the extent to which private equity can continue to deliver returns in line with history. For private assets overall, we think a key focus of constraint will be on its liquidity implications and ability to protect purchasing power—on that basis, not all private assets are equal.

At the aggregate level, this situation prompts fundamental questions about the end game for private assets, the implications for portfolio design, and how growth is funded in the economy. This relates to a theme that has been running through our research for some years: the goal for any individual portfolio manager is to maximize return per unit risk for their client, but the investment industry as a whole is increasingly focused on ensuring that economic growth is adequately funded. This theme prompts interesting questions as to not only the endgame for private assets but what the future holds for public markets.

We think all these topics will guide strategic decisions in the investment industry over the next few years and will remain important beyond the current business and electoral cycles.



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